DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 97-0521
INDIANA CORPORATION INCOME TAX
For Years 1993, 1994, and 1995

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ISSUE

I. **Reallocation of Taxpayer's Sales to Indiana**: Throw-back Sales.

Authority:15 U.S.C.S. § 381; IC 6-3-2-2(e); IC 6-3-2-2(n)(1); IC 6-3-2-2(n)(2); Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992). Indiana Dept. of State Revenue v. Continental Steel Corp., 399 N.E.2d 754 (Ind. Ct. App. 1980); 45 IAC 3.1-1-53(5); 45 IAC 3.1-1-64.

Taxpayer has protested the auditor's determination that certain of its sales, resulting in shipments from the taxpayer's plants inside Indiana but delivered to customers within other states, should be included in the throw-back calculation, relevant in determining taxpayer's corporate income tax liability, because the taxpayer's activities within those foreign states did not exceed solicitation. The taxpayer argues that because it is taxable within those other states, sales to those out-of-state customers should not be included within the throw-back calculation for purposes of determining Indiana Corporation Income tax.

STATEMENT OF FACTS

Taxpayer is a manufacturer of custom-designed plastic products. Ninety-six percent of taxpayer's business is generated through the design and manufacture of custom designed packing and shipping trays ("Transport Packaging Systems"). The remainder of taxpayer's business derives from the manufacture of small storage trays used in classrooms. The taxpayer is headquartered in Ohio. The taxpayer operates plants, owns various properties, controls inventory, and pays taxes in Indiana and Ohio. However, the taxpayer ships products from Indiana to states other than Indiana and Ohio.

ISSUE

I. **Reallocation of Taxpayer's Sales to Indiana**: Throw-back Sales.

Taxpayer protests the imposition of the Indiana adjusted gross income tax on the proceeds of sales made to certain of its out-of-state customers. The auditor determined that, for purposes of determining the taxpayer's tax liability, the sales to out-of-state customers should be allocated back to Indiana because the sales were made to customers located within states where the taxpayer was not subject to tax. Under 45 IAC 3.1-1-53(5), "[I]f the taxpayer is not taxable in the state of the purchaser, the sale is attributed to [Indiana] if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state." Such sales are designated as "throw-back" sales. Id. The auditor found that taxpayer's transactions qualified as "throw-back" sales because the taxpayer did not file out-of-state income or property tax returns, had no property or inventory in the foreign states, and was unable to provide definitive proof that the taxpayer was subject to out-of-state tax. The taxpayer conducts business in 39 states outside of Indiana but files income tax returns in only four of those states.

IC 6-3-2-2(e) provides that "[s]ales of tangible personal property are in this state if . . . (2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and . . . (B) the taxpayer is not taxable in the state of the purchaser." IC 6-3-2-2(n) provides that "[f]or purposes of allocation and apportionment of income . . . a taxpayer is taxable in another state if: (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax; or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not." Therefore, in order to properly allocate income to a foreign state, taxpayer must show that one of the taxes listed in IC 6-3-2-2(n)(1) has been levied against him or that the state has the jurisdiction to impose a net income tax regardless of whether the state actually does so.

15 U.S.C.S. § 381 (Public Law 86-272) controls those occasions in which a state may properly impose a tax on the net income, derived from sources within that state, by foreign (out-of-state) taxpayers. 15 U.S.C.S. § 381 establishes the minimum standard for the imposition of a state income tax based on the solicitation of interstate sales. Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447, 2453 (1992). 15 U.S.C.S. § 381 prohibits a state from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those business activities exceed the mere solicitation of sales. 15 U.S.C.S. § 381(a), (c). Conversely, the effect of the throw-back rule is to revert sales receipts back to the state from where the goods were shipped in those situations where 15 U.S.C.S. § 381 deprives the purchaser's own state of the power to impose a net income tax. 45 IAC 3.1-1-64. In effect, 15 U.S.C.S. § 381 permits Indiana to tax out-of-state business activities, without violating the commerce clause and without the possiblity of subjecting taxpayer to double taxation, because Indiana's right to tax those out-of-state activities is derivative of the foreign state's own taxing authority. In every transaction, at least one state has the authority to tax income derived from the sale of tangible personal

property; if the state wherein the sale occurred is forbidden to do so by 15 U.S.C.S. § 381, then the income is "thrown-back" to the originating state.

The definition of activity which does and does not exceed "mere solicitation" has been set out in Indiana Dept. of State Revenue v. Continental Steel Corp., 399 N.E.2d 754 (Ind. Ct. App. 1980). The court held that, "solicitation should be limited to those generally accepted or customary acts in the industry which lead to the placing of orders, not those which follow as a natural result of the transaction, such as collections, servicing complaints, technical assistance and training . . ." Id. at 759. Further, "solicitation must be limited to those acts which lead to the placing of orders and does not include those acts which follow as a result of the transaction." Id. The court set out examples of activity which exceeded "mere solicitation" including "giving spot credit, accepting orders, collecting delinquent accounts and picking up returned goods within the taxing state, collecting deposits and advances on orders within the taxing state, pooling and exchanging technical personnel in a complex mutual endeavor, maintaining personal property [] and associated local business activity for purposes not related to soliciting orders within the taxing state." Id.

In Continental, the court held that the taxpayer's activities within the foreign state exceeded solicitation because taxpayer's activities "[did] not lead to the placing of orders but follow[ed] as a natural result of the transaction." Id. Those activities included the taxpayer's "salesmen making adjustments on complaints, [and] salesmen giving customers technical assistance . . ." Id.

The "mere solicitation" standard was refined by the Supreme Court in Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co. 112 S.Ct. 2447, 2453 (1992). The Court concluded that "although solicitation covered more than what was strictly essential to making requests for purchases, the fact that an activity is performed by salespersons does not automatically convert that activity into solicitation." Id. at 2456-57. The Court held that whether the taxpayer's in-state activity was sufficiently de minimis to avoid the loss of taxpayer immunity, conferred by 15 U.S.C.S. § 381, depended on whether the activity establishes a "non-trivial additional connection with the taxing State." Id. at 2458. In Wrigley, the Court determined that the taxpayer's sales representatives' activities, consisting of replacing stale gum at retail locations, was an activity outside 15 U.S.C.S. § 381 immunity. Id. at 2458-59. The court held that although the representatives' activity could be said to facilitate the sales, it did not facilitate the *requesting* of sales and was not ancillary to the solicitation of sales. Id. at 2459 (Emphasis added). Therefore, because taxpayer's practice of having its representatives rotate stocks of stale gum was an activity outside the solicitation of sales, taxpayer brought itself outside the scope of 15 U.S.C.S. § 381 immunity and subjected itself to the local net income tax. Id. at 2460.

The nature of taxpayer's business is the production of large, plastic shipping trays custom designed to conform to the shipping requirements of the customer's particular products. The majority of taxpayer's customers are in the business of producing and shipping either television picture tubes or automobile parts. Each shipping tray is custom designed to conform to the size, weight, and form of the individual components and is further adapted to the particular means by which the components will be shipped. Each tray is designed to securely hold multiple components. Each tray is designed to stack atop an identical tray and, by this means, provide additional protection for the components sandwiched between the different levels of trays. The trays are specifically designed to fit within or on shipping pallets and/or various shipping containers.

Taxpayer retains salespersons to solicit orders for shipping trays. Once a sales representative has made an initial presentation and the customer has expressed an interest in taxpayer's product, a purchase order is prepared and signed. Although a "concept drawing" may have been prepared before the purchase order was signed, the more detailed collaborative design, engineering, and testing work occurs after the purchase is signed. Once that purchase order has been obtained, the salesperson or taxpayer's engineers – depending on the complexity of the desired tray – consults with the customer to design the specific tray required. Once taxpayer and customer have considered and agreed on the characteristics of the shipping tray, a wooden die is fabricated, sample plastic trays are produced, and the samples are shipped to customer for testing and approval. Simultaneously, taxpayer tests the samples at its own location. Once tested and approved, a final metal die is prepared. This metal die, at customer's choice, will remain the property of either taxpayer or the customer. If customer obtains ownership of the die, the customer is potentially free to retrieve the die, select another vendor, and, using the original die, have the replacement vendor produce additional trays. In approximately 82.8 percent of cases, customer acquires and retains ownership of the tooling although the die normally remains at the taxpayer's manufacturing facility. (Taxpayer Letter, November 10, 2000).

Whether taxpayer's collaborative design activities occur before or after a completed sale is question of fact and open to some degree of interpretation. In general, taxpayer regards the solicitation for the initial sale as "complete" before the design and engineering work is commenced. Taxpayer is of the opinion that it will not enter into extensive preparatory work until it has some degree of assurance that the sale is complete. However, there are instances where, after the design and engineering work is complete, the resulting product is found to be unsatisfactory and the customer will decline to purchase the taxpayer's products. What is undisputed is that 60 percent of taxpayer's business constitutes repeat business with existing customers. This degree of repeat business gives some evidence of a continuing and ongoing collaborative relationship between the taxpayer and its individual customers.

After an initial "run" of the trays is complete, the taxpayer remains in contact with the customer for various reasons. The salespersons or taxpayer's chief financial officer may contact the customer to resolve payment issues. The salesperson may contact customer to determine if additional trays are required. At the end of the useful life of the tray, either through wear or because the product specifications have changed, the taxpayer maintains an arrangement whereby it will repurchase the trays and recycle the component plastics in preparation for fabricating new packaging materials.

Taxpayer has provided documentation related to the amount of time, unrelated to an initial sale, its personnel spend at customer locations. Taxpayer's sales personnel spend an average of 3.5 days per week at customer locations. Members of the engineering department spend an average of ten days per month at customer locations. (Taxpayer Letter, November 10, 2000).

Standing alone, none of the taxpayer's isolated activities is sufficient to demonstrate that taxpayer's out-of-state activities exceed the "mere solicitation" standard established in 15 U.S.C.S. § 381 as defined in Continental, 399 N.E.2d 754. However, given the totality of the circumstances and the evidence as set forth by the taxpayer, the taxpayer's out-of-state activities go beyond "those generally accepted or customary acts in the industry which lead to the placing of orders" but evinces a relationship with its foreign-state customers that demonstrates an ongoing, complex, collaborative endeavor. Id. at 759. Compared to the business activity in Wrigley, wherein Wrigley, by rotating stocks of stale chewing gum, was found to have exceeded solicitation of sales, taxpayer's own foreign state activities are clearly even more extensive. Because taxpayer produces a custom designed product, the utility of which is dependent upon closely adhering to the customer's specifications and requirements, the simple solicitation of orders is insufficient to complete a customer transaction. The transaction takes place over an extended period of time and involves extensive consultations between customer and taxpayer in order to produce a product satisfactory to the customer. These consultations involve not only taxpayer's salespersons but also the taxpayer's engineers, design staff, and comparable numbers of the customer's own personnel. Such activity creates a sufficient nexus with the out-of-state jurisdiction such that only those foreign states have jurisdiction to tax the taxpayer. Id. The fact that taxpayer does or does not file an income tax return in those states, does or does not pay the pertinent tax in those jurisdictions, is irrelevant and is of no concern to the state of Indiana. Id. at 758; IC 6-3-2-2(n)(2).

FINDING

Taxpayer's protest is sustained subject to the findings of a supplemental audit.